Nos. 11070, 11071

In the United States Circuit Court of Appeals for the Ninth Circuit

BYRON C. HANNA, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

DAISY MAY HANNA, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 22–27)[1] are unreported.

JURISDICTION

These consolidated petitions for review involve income tax deficiencies for 1940 determined against Byron C.

[1] All record references, unless otherwise indicated, are to the complete record in No. 11071.

Hanna and his wife Daisy May Hanna. Deficiency notices were mailed to the taxpayers on November 17, 1942 (No. 11070, R. 11–16; No. 11071, R. 12–16). Within 90 days thereafter, on February 10, 1943, the taxpayers filed petitions with the Tax Court for redetermination of the deficiencies, under the provisions of Section 272 of the Internal Revenue Code (R. 1, both dockets). The Tax Court entered its decisions on January 15, 1945, ordering and deciding that there are deficiencies in income tax in the amount of $4,134.55 against Byron C. Hanna (No. 11070, R. 26–27) and in the amount of $3,476.26 against Daisy May Hanna (No. 11071, R. 28). Petitions for review by this Court were filed on April 12, 1945, pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code (No. 11070, R. 27–32; No. 11071, R. 29–34).

QUESTION PRESENTED

Whether the Tax Court erred in finding that less than 95 percent of the compensation for services rendered by a partnership of which one of the taxpayers was a member was paid on completion of the services and in holding, for that reason, that the taxpayers could not avail themselves of the method of computing the tax provided by Section 107, Internal Revenue Code.

STATUTE INVOLVED

Revenue Act of 1939, c. 247, 53 Stat. 862:

> SEC. 220. *Compensation for Services Rendered for a Period of Five Years or More.*
>
> (a) The Internal Revenue Code is amended by inserting after section 106 the following new section:
>
> "SEC. 107. *Compensation for Services Rendered for a Period of Five Years or More.*

"In the case of compensation (a) received, for personal services rendered by an individual in his individual capacity, or as a member of a partnership, and covering a period of five calendar years or more from the beginning to the completion of such services, (b) paid (or not less than 95 per centum of which is paid) only on completion of such services, and (c) required to be included in gross income of such individual for any taxable year beginning after December 31, 1938, the tax attributable to such compensation shall not be greater than the aggregate of the taxes attributable to such compensation had it been received in equal portions in each of the years included in such period."

(b) The amendment made by subsection (a) shall be applicable to taxable years beginning after December 31, 1938.

(26 U. S. C. 1940 ed., Sec. 107.)

STATEMENT

The Tax Court found the following facts (R. 23–26):

Byron C. Hanna and Daisy May Hanna, the taxpayers, were husband and wife, residents of California during 1940 and all other times herein mentioned. They filed individual income tax returns for that year on the community property basis with the Collector of Internal Revenue for the Sixth Collection District of California. During the taxable year and all other years herein mentioned Byron C. Hanna and Harold C. Morton were law partners known by the firm name of Hanna and Morton. (R. 23.)

In July 1932, Etienne Lang, as agent for the members of a Lazard family of France, consulted Hanna and Morton with reference to claims against the Anglo-California National Bank of San Francisco, Herbert Fleishhacker, its president, and others. These claims

arose out of certain acts of the Bank and Fleishhacker as agents of the Lazards in the sale some 17 years earlier of lands in California belonging to the Lazards. At that time Lang employed Hanna and Morton to render an opinion on the validity of the claims and to draft a specimen form of complaint. Lang paid Hanna and Morton $2,500 for these services. There was no obligation on the part of Lang or the Lazards to employ Hanna and Morton for further services and no obligation on the part of Hanna and Morton to accept such employment. (R. 23.)

In October 1932, after consulting with other lawyers, Lang employed Hanna and Morton to proceed with the case. Lang and Morton agreed that $27,500 would be advanced to Hanna and Morton to cover costs and expenses, with the understanding that if any balance should remain at the conclusion of the employment, it would belong to Hanna and Morton. It was understood that Hanna and Morton received these funds for such purposes only and the accounts of Hanna and Morton dealing with the funds were frequently inspected by Lang. The books of Hanna and Morton designated the fund as a "Trust Account." The $27,500 was paid over on October 15, 1932, and the receipt given for it read "Lazard Matter, On Account, Trust Acct." It was further agreed that Hanna and Morton would be responsible for any expenses beyond the $27,500. In addition to any balance remaining of the $27,500 their fee was to be 15 per cent of the recovery. (R. 23–24.)

For some time, $20,000 of the fund was left on deposit in the firm's name in two savings banks. Lang knew and approved of this. The funds were never kept in a

separately designated trust account. Lang knew of this and acquiesced in it. (R. 24.)

A total of $1,168.86 in interest accrued on the savings accounts. During the years 1934 to 1936, Hanna and Morton withdrew this interest for their own unrestricted use having been told by Lang that they could keep it. They were to return it if it ever became necessary to complete the payment of expenses, their obligation in any event being to meet all expenses over the $27,500. The interest so received was currently reported as income by Hanna and Morton. This interest was a fee for services when it was so withdrawn by Hanna and Morton. (R. 24–25.)

Lang agreed to the withdrawal of $2,000 by Hanna and Morton as fees at the time the $27,500 was first paid over in October 1932. Later in the same month an additional $1,500 was withdrawn as a fee with Lang's approval. A further fee withdrawal of $1,000 was made on May 1, 1933, with Lang's permission and again on October 31, 1936, Lang gave Morton his consent for the firm to withdraw $1,000. Each of these fees was paid subject to the understanding that Hanna and Morton were to make up any deficits for expenses beyond the original amount paid to them for that purpose. They included these fees as compensation in their income tax returns in the years received. (R. 25.)

Hanna and Morton successfully tried the case for the Lazards and on January 19, 1940, the Bank paid $746,-354.95 in satisfaction of the judgment. From this amount Hanna and Morton received on that day $114,018.19, consisting of the contingent fee in the amount of $111,-588.84 and $2,429.35 reimbursement of costs expended

from the $27,500 fund. At that time, exclusive of the reimbursement for costs, there was a balance of $7,769.55 of the original $27,500 which Hanna and Morton also received pursuant to the arrangement previously made. Thus, Hanna and Morton received fees of $1,168.86 and $5,500 prior to completion of the services in 1940 and $121,787.74 on completion of these services in 1940. (R. 25.)

Viewing the original payment of $2,500 as being for a separate and distinct employment, addition of these figures indicates that a total fee of $128,456.60 was received by Hanna and Morton on this case. Of this amount, $121,787.74, or 94.8 percent, was paid on the completion of the services. (R. 25–26.)

The Tax Court held that the taxpayers were not permitted to use the method for computing the income tax provided by Section 107 of the Internal Revenue Code because the portion of the compensation received upon completion of the services was less than 95 percent of the total compensation. (R. 27.)

SUMMARY OF ARGUMENT

The taxpayers cannot avail themselves of the special method for computing tax liability provided by Section 107 of the Internal Revenue Code, because the portion of the compensation received on completion of the services was less than 95 percent of the total compensation. Congress has drawn the line with mathematical exactness and no interpretation, however liberal, could permit application of Section 107 in this case even though *almost* 95 percent was received on completion of the services.

This Court recently said in *Lindstrom* v. *Commissioner*, 149 F. 2d 344, 346, that the provisions of Section 107 are to be strictly construed.

There is no error of fact or law in the Tax Court's determination. The $5,500 withdrawn from the trust account for expenses before 1940 is admittedly part of the total fee. The contingency that all or a portion of this amount might have had to be restored in the event that future expenses exceeded the balance in the trust account could not prevent the $5,500 from being treated as partnership income immediately upon its receipt. The controlling principle of law was early recognized by this Court in *Burnet* v. *North American Oil Consolidated*, 50 F. 2d 752, affirmed, 286 U. S. 417, and the present case is no exception.

The accumulated interest of $1,168.86 which the clients permitted the partnership to withdraw before 1940 was paid as compensation and was not a gratuity. Factually, the accumulated interest was treated identically with the withdrawals totaling $5,500, which admittedly were fees. There are no facts in the record which lend support to the contention that the clients made a gift of the accumulated interest.

The Tax Court's determination from the record that the controverted items were compensation when they were received is conclusive. By reason of the prior receipt of compensation totaling $6,668.86 the partnership received less than 95 percent of the total compensation for these services in 1940 and Section 107 does not apply.

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ARGUMENT

The special method for computing tax liability provided by Section 107, Internal Revenue Code, is not available here

Section 107 of the Internal Revenue Code, *supra*, as applicable in 1940, provides for a special method of computing the income tax with respect to compensation for services rendered for a period of five years or more. Clause (b) of Section 107 limits that special method to cases where not less than 95 percent [2] of the compensation is paid on completion of the services. The issue in this case is whether the Tax Court erred in holding that the portion of the compensation paid in 1940 was less than 95 percent of the total compensation and, therefore, that Section 107 was not available to the taxpayers.

This Court recently had occasion to consider the interpretative policy underlying Section 107 in *Lindstrom* v. *Commissioner*, 149 F. 2d 344, involving an attempt to tack services rendered by a law partnership onto services previously rendered individually by one of the partners. This Court said (p. 346):

> The legislative provision here considered (Section 107) constitutes an exception to the general rules governing the taxation of income. Its obvious purpose was to alleviate tax hardships resting on long-term workers who receive compensation upon the completion of their services, but we do not believe that the relief afforded by this section covers the situation presented here. The taxpayer claiming its benefits must bring himself within the letter of the Congressional grant. * * *
>
> The will of Congress has been plainly expressed

[2] The line is now fixed at 80 percent by Section 107, as amended by Section 139(a), Revenue Act of 1942, c. 619, 56 Stat. 798 (26 U. S. C. 1940 ed., Supp. IV, Sec. 107).

> in language that does not permit or require a strained or unnatural interpretation. The words of the statute may not be extended or distorted beyond their plain, popular meaning. [Citations omitted.]
>
> The Supreme Court points out that provisions granting special tax exemptions are to be strictly construed. [Citations omitted.]

In the face of this clear expression, the taxpayer asserts, without referring to the *Lindstrom* case, that Section 107 should be given a "liberal" interpretation which would make its benefits available in a case where the payment on completion of the services is less than the 95 percent or more required by the statute. (Br. 16–20, 27–29, 39–41). We submit that no process of interpretation, however liberal, could construe "not less than 95 per centum" as meaning "not less than 94.8 per centum", or "almost 95 per centum". Congress has drawn the line with mathematical exactness and there is no room for interpretation. The statutory language is plain and unambiguous, and, therefore, *Slough* v. *Commissioner*, 147 F. 2d 836 (C. C. A. 6th), and the other cases cited by the taxapayers are of no aid to them. (See Br. 17–20.) Contrary to the taxpayers' contention (Br. 39–40), the taxpayers are not subjected to any penalty by reason of their inability to avail themselves of the special method for computing the tax afforded by Section 107. They are merely placed on the same footing with all other income taxpayers whose income is taxed as it is received.

The taxpayers allege (R. 32, Br. 14) that the Tax Court erred "in finding as a fact or deciding as a matter of law" that the partnership of Hanna and Morton received a total of $6,668.86 as fees for services before 1940 (R.

24–26, 27). We fail to discern any error of fact or law in the Tax Court's determination.

The Tax Court's opinion proceeds on the assumption that the partnership's treatment of the $27,500 received in 1932 as a special trust account was conclusive for tax purposes and that the $27,500 was not includible in the partnership's 1932 income.[3] See, however, *Commissioner* v. *Alamitos Land Co.*, 112 F. 2d 648, 651 (C. C. A. 9th), certiorari denied, 311 U. S. 679. Presumably, the Tax Court considered the circumstances surrounding the $27,500 payment to be such that the fund was not immediately and unrestrictedly available for general partnership use. That was not the case, however, as the taxpayer's brief recognizes (pp. 25–26), with respect to the amounts, totaling $5,500, which were withdrawn from the special account from time to time in 1932, 1933 and 1936. These amounts were withdrawn for general partnership use with the client's permission and they were treated as fees on the partnership's records. (R. 49–52, 63–67, 73, 96, 109–110). The partners reported these items as compensation in their income tax returns for the years in which they were received. (R. 25.)

Now, although the taxpayers concede (Br. 5) "that the advances of $5,500.00 constituted a part of the total fee", they contend that the items aggregating this sum should not be treated as income or compensation until 1940. The only reason advanced for delaying taxation of these items beyond the years in which they were received is that the partnership, having undertaken to pay all of the expenses of the litigation, would have to make up any deficits in the

[3] The portion of the taxpayers' brief (pp. 21–26) which is devoted to a discussion of the taxable status of the $27,500 payment is not in point, since the question is not now in issue.

expense account in the event that future expenses exceeded the balance remaining in that account. This contingency, it is asserted, requires that the $5,500 be treated as an "advance" or a "loan" until 1940, when the expenses of the litigation were finally determined. (Pet. Br. 27–29.)

The record shows that the contingency of which the taxpayers make so much was indeed very remote. Mr. Morton, the partner who arranged for the $27,500 payment, testified that he had estimated that the expenses of the litigation (R. 63) "might be $20,000—it might be $10,000, $20,000 or $30,000." Thus, the $27,500 set aside for expenses approached the highest figure estimated. Mr. Hanna also testified (R. 63–64) as to the $3,500 which was almost immediately taken and used by the firm that (R. 64):

> We did not know that we would have to have that for expenses *except for legal fees for ourselves.* [Italics supplied.]

It is clear that both the attorneys and the clients recognized that $27,500 was more than enough to cover the anticipated expenses and that it was almost a certainty, even at that early date, that at least $3,500 could be withdrawn immediately by the attorneys as fees. As the work progressed, the future expenses could, no doubt, be forecast with greater accuracy, and the withdrawals of $1,000 in each of the years 1933 and 1936 were conservative indeed, considering that the total cost paid from 1932 through 1940 was only $14,230.45. (R. 110.) It must also be observed that the clients did not hold the attorneys strictly to their agreement to pay all of the expenses out of the $27,500, because at the termination of the litigation the clients reimbursed the attorneys to the

extent of $2,429.35 of costs which had been expended from the $27,500 fund. (R. 25.) It is reasonable to conclude that the partners never really expected to have to pay out for expenses the amounts which they had received as fees.

This Court early recognized the general principle which requires that, in spite of the contigenency, the various amounts withdrawn from the trust account be treated as taxable income for the respective years in which they were made available for general partnership use. In the leading case of *Burnet* v. *North American Oil Consolidated*, 50 F. 2d 752, this Court rejected the taxpayer's contention that income actually received in 1917 was not taxable until 1922 because the right to retain the income was in litigation until the latter year. In affirming the judgment of this Court, the Supreme Court said (*North American Oil* v. *Burnet*, 286 U. S. 417, 424):

> If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent. * * *

A similar effort to exclude from gross income a portion of the premiums earned by an insurance agent which might have to be restored in future years was later rejected by this Court and also affirmed by the Supreme Court. *Brown* v. *Commissioner*, 63 F. 2d 66 (C. C. A. 9th), affirmed, 291 U. S. 193. The principle declared in *North American Oil* v. *Burnet*, *supra*, has been uniformly

followed in a long line of cases and *Knight Newspapers* v. *Commissioner*, 143 F. 2d 1007 (C. C. A. 6th), cited and quoted by the taxpayers (Br. 27–29), does not purport to depart therefrom. See annotation on the *Knight Newspapers* case at 154 A. L. R. 1276. To adopt the method of reporting income contended for by the taxpayers would require a departure from the fundamental rule that income is determined and taxed on an annual and not a transactional basis. *Security Mills Co.* v. *Commissioner*, 321 U. S. 281; *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359. The withdrawals totaling $5,500 were immediately and unrestrictedly available to the partners and they made no mistake in reporting the several items as income for the years in which they were received, in spite of the remote contingency that future expenses might exceed the balance remaining in the expense account.

There is also no merit in the contention (Pet. Br. 29–39) that the accumulated interest of $1,168.86 which the clients permitted the partnership to withdraw for its own use before 1940 was a gratuity rather than compensation for services. The interest belonged to the clients initially and it was withdrawn for partnership use only after the permission of the clients was obtained. (R. 72.) Mr. Morton testified (R. 71–72) and the Tax Court found (R. 24) that the interest would have had to be returned, in the same manner as the $5,500 which the taxpayers admit to have been fees (Br. 5), if it ever became necessary to complete the payment of expenses. The interest so received was currently reported as income by the partners. (R. 24.) The facts all support treatment of this

item as compensation and they permit no inferences to the contrary.

In the face of these facts, and the other evidence of record pertaining to the circumstances under which the partnership was permitted to withdraw the accumulated interest (R. 67–77), the taxpayers contend that the interest was received by the partnership as a gratuity and not as compensation for services. There is absolutely no support in the record for this contention. Reliance is sought to be placed upon the provisions of the contract pertaining to the manner in which the partners were to be compensated for their services (R. 53–54) but those provisions do not negative the Tax Court's finding, because there is nothing to prevent the payment of additional compensation. In any event, the source of the Tax Court's finding could not be limited to the contract alone since the parties failed to adhere to the contract right from the start and it did not express their real agreement. (R. 54, 64, 85–87, 92, 94–95, 101–107.) If the contract were to be taken literally, the $27,500 would have had to be treated as compensation for 1932, in which case the final payment in 1940 would have been far less than the 95 per cent required by Section 107.

It was for the Tax Court to determine as a matter of fact whether the interest was received as compensation or as a gratuity and, also, whether the $5,500 was received as compensation or as a loan. *Commissioner* v. *Smith*, 324 U. S. 177, rehearing denied, September 9, 1945 (1945 C. C. H., par. 9253). On the record before it, the Tax Court could find only, as it did, that these amounts were received as compensation for services. That finding is

conclusive.[4] *Commissioner* v. *Smith, supra; Dobson* v. *Commissioner*, 320 U. S. 489, rehearing denied, 321 U. S. 231. See also *Trust u/w of Bingham* v. *Commissioner*, decided by the Supreme Court, June 4, 1945 (1945 C. C. H. par. 9327); *Choate* v. *Commissioner*, 324 U. S. 1; *Commissioner* v. *Court Holding Co.*, 324 U. S. 331. By reason of the prior receipt of compensation totaling $6,668.86 the partnership received less than 95 percent of the total compensation for these services in 1940 and Section 107 does not apply.

[4] Although *Bogardus* v. *Commissioner*, 302 U. S. 34, cited by the taxpayers (Br. 15, 34), was a case in which the Supreme Court reversed a determination of the Board of Tax Appeals that a particular item was taxable as compensation and not a gift, that case was specifically referred to by the Supreme Court as one of those in which the courts, including the Supreme Court, had "not paid the scrupulous deference to the tax laws' admonitions of finality which they have to similar provisions in statutes relating to other tribunals" than the Tax Court. *Dobson* v. *Commissioner*, 320 U. S. 489, 494 fn. 8,498 fn. 22.

CONCLUSION

The decisions of the Tax Court are correct and should be affirmed.

Respectfully submitted.

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